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¶1. (SBU) Summary. We met three Istanbul-based bankers with visiting Turkey desk officer to discuss economic performance, trends and political risk. All three thought that the AKP government had done a good job implementing IMF-backed reforms, but felt that the AKP economic team lacked depth and had been unable to formulate a long-term economic strategy of its own. The current account deficit and the effect of political risk on the economy were primary concerns, but both were seen as manageable in the short to medium term. End Summary.

Enormous Progress Despite a Weak Team

¶2. (SBU) Baturalp Candemir of EFG Securities told us that despite personally disagreeing with the AKP on virtually every social issue, he felt that AKP had made enormous progress on both economic and political reforms an assessment echoed by Steve Bideshi of Citigroup and Idil Dagdalen of Bender Securities. Candemir explained that he is much less pessimistic than he was only two years ago. He is no longer concerned about the possibility of a debt crisis because the structural reforms of the past several years have shielded the economy, particularly the banking sector, from external shocks. Bidishi agreed, noting that Citigroup's internal projections give a 65% chance that the economic situation will remain the same over an 18 month horizon. This factors in the early November EU 'report card' as well as upcoming presidential and parliamentary elections and contrasts with 2005 projections that gave a 70% chance for stability.

¶3. (SBU) Candemir cited three broad areas of improvement during the AKP government: fiscal policy, changes to the social security system and the situation with regard to the EU. Candemir argued that the AKP government has not only established better fiscal policy but also created a public recognition of the need to "pay for" budgetary outlays that was lacking in the past. Additionally changes to the social security system have limited the deficit in that system to approximately 4.5% of GDP, heading off a projected increase in the deficit. He expects that figure to remain constant for the next two to three years and then to gradually decrease to 2-3% of GDP over the subsequent decade. Finally, he argued that worries over the Cyprus ports issue notwithstanding, relations with the EU were clearly better than five years ago.

¶4. (SBU)In a complaint voiced by all three bankers, Candemir

complained that the AKP government lacked a long-term economic vision and cannot strategize. Candemir and Bideshi argued that recent reforms were simply the result of mechanically implementing IMF and World Bank recommendations, an overly simplistic assertion in our view and one that government officials would vehemently deny. Dagdalen conceded that point, but argued that it was better to have no economic vision than a "bad" economic vision and that lack of a competing economic philosophy made it easier for the current government to implement reforms than it might for a government controlled by the "statist dinosaurs" of the opposition CHP. Comment: We would frame the issue differently -- the AKP may not have a well-thought out long-term economic strategy of its own, but it clearly has free-market, pro-reform instincts that stand in sharp contrast to the reflexive statist impulses that are the norm within other political parties and the upper reaches of the secular establishment. (See reftel) The government has gone beyond the IMF's minimum requirements and shown real political courage on privatization, foreign investment and in going after the owners of failed banks. End Comment.

¶5. (SBU) All three bankers agreed that the AKP economic team lacks depth and that Economy Minister Babacan was overstretched by his additional responsibilities with the EU. Bidishi argued that Babacan, who is "outstanding," needs to more visibly support Central Bank Governor Durmus Yilmaz who has had a difficult first few months in office. Bidishi felt that both Yilmaz and Finance Minister Unakitan were hard workers, but noted that
Unakitan does not "present well" particularly with international audiences. Candemir argued that the economic administration had grown overconfident and was taking credit for several years of strong economic growth that were more a

reflection of global conditions in emerging markets and IMF reforms than AKP economic policy per se. Candemir also noted that the AKP policy team does not trust career bureaucrats - who tend to be vehemently secular. In the same vein, Dagdalen noted the AKP government is unable or unwilling to call upon technocrats in the way the Ecevit government did with Kemal Dervis in 2000. She argued they will not pull in outsiders even at the mid-levels and that this has exacerbated the lack of economic expertise at the top.

Inflation, Interest Rates, Investment and the Current Account Deficit

¶6. (SBU) We asked how long it would take for interest rates to go down and how this had affected consumer credit. Bidishi thought that interest rates were unlikely to go down before mid-2007 and then only if inflation was under control. The rate of credit expansion has reduced. In particular car sales have decreased due to higher interest rates, however export sales benefited from the weaker lira leaving a net neutral effect on the auto industry. Bidishi noted that even during the spring volatility Turks did not sell lira to buy dollars. There was a cashing out effect as Turks sold dollars to benefit from favorable rates, but unlike in previous years there was no massive shift from lira to dollars as the lira fell. We asked whether the lira had rebounded to the point where it was overvalued. All three thought that the lira would eventually stabilize at 1.55 to the dollar (slightly weaker than current rates.)

¶7. (SBU) We asked how the government could best deal with the current account deficit. Candemir argued that if the lira stabilized at 1.55 and growth held at 6% the current account deficit would fall to manageable levels within four to five years. Dagdalen argued that the current account deficit - presently approximately $30 billion or 8% of GDP - is "too big to ignore." Turkey's manufacturing sector uses a large amount of imported inputs, so increasing exports alone will not significantly reduce the current account deficit.

Foreign direct investment has helped to finance the deficit, but she argued this is not sustainable.

¶8. (SBU) Foreign investment in Turkey can be divided into three broad categories: foreign direct investment, experienced (with Turkey) financial investors and financial investors without significant experience in Turkish markets. Candemir noted that foreign direct invstment was largely unaffected by the exchange rae volatility earlier in the year. He was surpried when deals went through without suspensions o even demands for price concessions citing Petro Ofisi and Vakifbank. We noted that FDI remains elatively low given the size of Turkey's economy de to investor concerns regarding inflation and crruption. Candemir argued that FDI was understatd in official figures because companies registered transfers as intracompany lending rather than FDI as an inflation shield and tax hedge. Bidishitold us that Citigroup views Turkey as a good plac to invest. Explaining that it was important toview investments in context, Bidishi argued that Turkey had a more open financial sector and thus more opportunity tha n China, Russia, India or Brazil.

¶9. (SBU) Experienced financial investors expect liquidity to evaporate when problems occur that affect Turkish markets. Candemir and Dagdalen expect experienced financial investors to return fairly quickly. Inexperienced financial investors were attracted to the market when the EU opened accession negotiations. Many of these investors were caught off-guard by the spring liquidity crunch, and were badly hurt (with some investors losing 30 %.) Although some of these investors have remained in the market, Dagdalen expects most of them to cash out after recouping some portion of their losses. Candemir expects it will be hard to re-attract these investors, particularly at the aggressive levels of 2005 and the first four months of 2006.

Conclusion and Comment

¶10. (SBU) Despite political and social misgivings, even our normally skeptical financial markets observers give credit to the current government for economic reform. We tend to agree, noting that the AKP government's commitment to free-market, pro-business policies and hold on the Parliamentary majority have enabled the implementation of IMF-backed reforms. These reforms, combined with generally

positive trends in the emerging markets, have fueled three years of strong growth.
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